No. 6856

In the United States Circuit Court of Appeals for the Ninth Circuit

HARRY A. DAUGHERTY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

UPON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR RESPONDENT

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INDEX

CITATIONS

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OPINION BELOW

The only previous opinion in this case is that of the Board of Tax Appeals (R. 22–24), which is reported in 24 B. T. A. 531.

JURISDICTION

This appeal involves a portion of the deficiency in income taxes asserted by the respondent for the year 1926 and is taken from an order of redetermination in the United States Board of Tax Appeals promulgated October 31, 1931. (R. 25.) The case is brought to this Court by petition for review filed February 11, 1932 (R. 25–29), pursuant to the Revenue Act of 1926, c. 27, Sections 1001, 1002, 1003, 44 Stat. 9, 109, 110.

QUESTION PRESENTED

Petitioner and others accepted a written appointment to act as attorneys in a will contest. The contract provided that they were to receive for their services a certain percentage of the amount recovered. Their client prevailed and paid the fee agreed upon. The question is whether petitioner is liable for the tax on his entire share of the fee or only on one-half thereof because of his assignment to his wife of an undivided one-half of his interest in the contract.

STATUTE INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 23:

> SEC. 213. * * *
>
> (a) The term "gross income" includes * * * compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, * * * or * * * income derived from any source whatever. * * *

STATEMENT OF FACTS

The facts found by the Board of Tax Appeals are substantially as follows (R. 16–22):

In 1915 petitioner was employed as one of the general attorneys of the Standard Oil Company of Indiana. Prior to that time and while engaged in the general practice of law he had acted as attorney for Mrs. Estelle Howland (then Mrs. Estelle Jennings) daughter-in-law of John D. Jennings and sister-in-law of Edwin Jennings. In about 1912 petitioner and Robert J. Folonie were engaged in

litigation to establish Mrs. Howland's rights in connection with the trust estate created by John D. Jennings, who died in 1889. Petitioner and Folonie spent a great amount of time and effort on the case, which was strenuously contested, but finally the litigation terminated unsuccessfully to Estelle Howland in the Appellate Court of Illinois. Certain adverse interests were represented by the law firm of Campbell and Fischer of Chicago, of which John G. Campbell was a member.

On October 31, 1923, Edwin Jennings, the last surviving son of John D. Jennings, died. Learning of his death, Campbell called petitioner on the telephone and asked him if he still represented Mrs. Howland and petitioner stated that he did. Campbell then stated that in connection with the prior litigation he had studied and briefed the question of Mrs. Howland's rights in the trust estate and that he had reached the conclusion that in view of the death of Edwin Jennings Mrs. Howland was entitled to a substantial interest therein. Campbell offered to give this brief to petitioner. Petitioner said he would ascertain the wishes of his client with regard to the matter, but that in no event could he handle litigation for her, because his position with the Standard Oil Company of Indiana occupied all of his time and attention. It was orally agreed between Campbell and petitioner that petitioner would not engage in any of the litigation but that petitioner was simply to furnish the client.

On November 3, 1923, Mrs. Howland conferred with petitioner and informed him that she desired proceedings instituted to establish her rights in the trust estate. At a conference between Mrs. Howland, her husband, petitioner, and Campbell at petitioner's offices in the Standard Oil Company building in Chicago it was agreed that a bill to construe the will should be filed; that all of the work in connection with the proceedings should be performed by Messrs. Campbell and Fischer, and that there should be paid to the attorneys an amount equivalent to 40 per cent of whatever might be recovered for Mrs. Howland, this amount to be divided equally between Campbell, Fischer, petitioner, and R. J. Folonie, whose name was suggested by petitioner because of his connection with petitioner in the prior unsuccessful litigation for Mrs. Howland. An agreement in writing was entered into as follows:

CHICAGO, ILL., *Nov. 5, 1923.*

I hereby appoint HARRY A. DAUGHERTY, ROBERT J. FOLONIE, JOHN G. CAMPBELL, AND HERMAN A. FISCHER, Jr., to act as my solicitors and attorneys in all matters pertaining to my interest in the Trust Estate founded by the last Will of John D. Jennings, deceased. They are authorized to commence or participate in, any proceedings they deem necessary in order to establish my interest therein. As their full compensation for services they are to receive an amount equal to forty per cent (40%) of any money or property I am awarded or receive in connection with the subject matter of said

Trust Estate; it being agreed and understood that this compensation is to be in addition to any fees which may be awarded, either to me on account of my solicitors' fees, or directly to my solicitors, by any Court, from the Trust Estate as a whole, on account of legal services rendered by them in any suit or suits which they instituted or participated in involving the subject matter above mentioned, but does not include anything which I may receive directly from the estate of Edwin Jennings, deceased, as distinguished from said Trust Estate, found by the Will of John D. Jennings, deceased.

(Signed) Estelle G. Howland,
Francis H. Howland,
Hoboken, N. J.

Accepted:
Harry A. Daugherty.
Robert J. Folonie.
John G. Campbell.
Herman A. Fischer, Jr.
By H. A. Daugherty.

It was agreed between the attorneys and Mrs. Howland that petitioner and Folonie would be required to do no work whatever in connection with the case.

On November 3, Campbell and Fischer filed the bill to construe the will. There were numerous parties to the litigation and a great deal of time and effort was put on the case by Campbell and Fischer. No time whatever was put in on the case and no work of any kind was done on the case by petitioner

or by Folonie, although Campbell signed petitioner's and Folonie's names to the pleadings in the litigation.

On January 30, 1924, petitioner wrote a letter to his wife (R. 20–21), enclosing petitioner's copy of the original contract with Mrs. Howland. On the margin of such contract petitioner endorsed an assignment in longhand as follows:

> CHICAGO, ILLINOIS, *Jan. 30, 1924.*
>
> In consideration of love and affection I hereby assign to Elizabeth M. Daugherty, my wife, an undivided one-half of my interest in and to this contract.
>
> HARRY A. DAUGHERTY.

The letter and the contract with the assignment endorsed thereon were delivered by petitioner to his wife on the evening of January 30 and were retained by her in her private desk at home until requested by petitioner for use in connection with the controversy over petitioner's income tax liability. Petitioner orally advised Campbell of the assignment some time in 1925.

At the time of the gift the litigation to which the contract related was pending and undetermined. No settlement had then been arrived at and there was then no assurance that the litigation would terminate successfully or that any settlement could be made. At the time of the gift the value of petitioner's interest in the contract and the value of the interest transferred by petitioner to his wife was wholly contingent and undeterminable.

In June, 1926, as a result of negotiations between the parties, in which petitioner in no way participated, a settlement of the litigation was agreed upon, by the terms of which $943,605.60 was awarded to Mrs. Howland in satisfaction of her claim. Pursuant to the contract of employment, 40 per cent thereof, or $377,442.24, was duly paid to Campbell and Fischer. Campbell called petitioner to his office in order to figure out just what each attorney was entitled to receive. Petitioner's wife was not invited to such conference. On June 22, 1926, Campbell delivered to petitioner a check in his favor in the amount of $47,180.28 and a check in favor of Mrs. Daugherty in the amount of $47,180.28.

Mrs. Daugherty deposited (or caused to be deposited) this check in an account which she opened in the Illinois Merchants Trust Company, a down-town bank in Chicago. She invested the money in stocks, secured the certificates in her own name, and deposited them in her private safe deposit box. She used the dividends of the stocks entirely for her own purposes and she did not contribute in any way to the household expenses, nor did petitioner derive any benefit whatsoever from the money paid to his wife nor from the securities purchased therewith nor from the dividends received by Mrs. Daugherty on such securities.

Respondent included in petitioner's gross income the amount of $47,180.28 received by petitioner's

146807—32——2

wife. The Board affirmed the Commissioner's action and the petitioner appeals.

SUMMARY OF ARGUMENT

The income which petitioner assigned to his wife was derived from personal services. Such income is by force of the statute taxable to the one who earns it and the tax attaches before such income passes from him by a transfer to take effect in the future.

The contract of November 5, 1923, was an ordinary employment contract whereby the petitioner and other agreed to perform legal services in a will contest for a fixed consideration. After services were performed it fixed the measure of compensation. Hence, it is clear that the services rendered were the source of the income and not the contract, which merely limited the amount of the income to be received. Unless services were performed the contract created no present property right in itself productive of income, and if this is true an assignment of the contract, or any part of it, could not transfer an income-producing property right. Assuming that all services were fully performed prior to the receipt of the compensation, the assignment of the right to the compensation is ineffective "to prevent the salary when paid from vesting even for a second in the man who earned it." *Lucas* v. *Earl*, 281 U. S. 111.

ARGUMENT

An assignment of income derived from compensation for services rendered is ineffective to relieve the assignor of the tax due thereon

Petitioner relies upon the well-established rule that income is taxable to the owner of the income-producing property. He urges that the income which the Commissioner taxed to him was properly taxable to his wife since she and not he was the owner of the corpus which produced it. Petitioner argues that this corpus was the employment contract, one-half of his interest in which he had transferred to his wife. It is submitted that the income in question represented compensation received for services rendered and is taxable to the petitioner before it changes its character in the hands of another.

The controlling case is *Lucas* v. *Earl*, 281 U. S. 111. It involves an assignment making the assignee a joint tenant of salaries and fees. Earl and his wife agreed in 1911 that any property either of them had or therafter might acquire in any way (including salaries, fees, etc.) would be treated and considered as owned by both as joint tenants. The question was whether the whole of the salaries and attorneys' fees earned by Earl in 1920 and 1921 should be taxes to him or only one-half, under that portion of Section 213 (a) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1065), directing the inclusion in the taxpayer's gross income of "gains, profits, and income derived from salaries, wages, or compensation

for personal service." In holding the former, the Supreme Court said (pp. 114–115):

> It [this case] turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

So here we contend that the anticipatory arrangement by which the petitioner diverted his personal earnings to his wife is ineffective to relieve him of the tax imposed by Section 213 (a) of the Revenue Act of 1926 which is identical with the same provisions in the 1918 Act.

Petitioner asserts (Br. 12) that in the *Earl case* there was no contract to which an assignment could attach and no *res* or property which was susceptible of assignment while in the case at bar there was a valuable contract which was income-producing and which constituted an assignable property right of the petitioner. It is thus sought to group the contract of November 5, 1923, with such income-producing property as a lease, bond, or building, which if assigned would concededly relieve the assignor of the tax on the income

therefrom. But the analogy sought to be drawn is not applicable for the reason that the income in question was derived as compensation for the performance of services and not from the agreement of November 5, 1923. That contract of itself could produce no income unless personal services were rendered. It was an ordinary employment contract creating a relationship of attorney and client and stating the object of the employment and the rate of compensation agreed upon. Even without the contract compensation would have been forthcoming to the extent of the value of the services rendered, a fact which indicates that the income-producing source was the service and not the employment contract.

The only property right which the contract created in the petitioner was the relationship of attorney and client. This relationship is hardly susceptible of assignment, especially to a person not a member of the bar. See citation from Pollock on Contracts (4th Ed. p. 425) in *Arkansas Smelting Co.* v. *Belden Co.*, 127 U. S. 379, 388. In the hands of the present assignee it would obviously be incapable of producing income. It is plain that what was assigned was petitioner's earnings from services rendered. That such was the petitioner's intention is disclosed in the last paragraph of his letter of January 30, 1924 (R. 20–21), in which it is stated:

> If we are successful, Mrs. Howland will realize a very substantial amount, and the contingent fee will be correspondingly large.

> I am therefore assigning to you an undivided one-half interest in my share of whatever fees may be coming to me under the contract.

Petitioner stresses the fact that his associates actively conducted the litigation and not the petitioner. But the essence of an agreement such as was made here is that the joint parties sustained to each other the relationship of mutual agency. Whatever steps his associates may have taken in this litigation were in legal effect the acts of the petitioner. Mechem on Agency, Vol. I (2d Ed.), pp. 141–145; *Mason* v. *Wolkowich*, 150 Fed. 699 (C. C. A. 1st). He did in fact perform the very valuable service of furnishing his associates with a client and of providing Mrs. Howland with a firm of attorneys to conduct her litigation. He also did agree to represent Mrs. Howland as her attorney, a fact of great importance to Mrs. Howland. Petitioner agrees that the sum in question is taxable. It can be taxable only on the theory that it was compensation for services and, since such income is taxable when received, it is immaterial whether the compensation was paid for reasons other than the active participation in the suit. But even if it is assumed that petitioner rendered no further service after attaching his signature to the employment contract, the assignment did not constitute a transfer of a property right but remained an equitable assignment of future income making the wife beneficial owner with only a derivative interest in his income.

The *Earl case* does not draw any distinction between compensation paid for past services and that paid for services to be rendered. The broad language of the decision destroys any ground for such distinction. The Court held that the import and intent of the statute is to tax salaries to those who earned them and that no one can by any arrangement prevent a salary when paid from vesting in himself. Petitioner's contention if accepted would permit salaried and professional men to deflect to others compensation paid for past services and thus reduce and even avoid the payment of surtaxes.

The respondent's view is supported by further authority. In *Bishop* v. *Commissioner*, 54 F. (2d) 298 (C. C. A. 7th), an insurance agent assigned to his wife all his interest to and in one-third of all renewal commissions thereafter to become due to him under his agency contracts. The court held that the assignment was of future income and not of any present property right in itself productive of income and that the renewal commissions were therefore taxable to the agent and not to the assignee. To the same effect is *Parker* v. *Routzahn*, 56 F. (2d) 730 (C. C. A. 6th), certiorari denied, No. 134, October Term, 1932; *Luce* v. *Burnet*, 55 F. (2d) 751 (App. D. C.); *Blumenthal* v. *Commissioner*, 60 F. (2d) 715 (C. C. A. 2d). In *Reynolds* v. *McMurray*, 60 F. (2d) 843 (C. C. A. 10th), it was said that the tax is imposed by force of the statute itself immediately when the income is derived, actually or constructively, and

the tax attaches before such income passes from the recipient by a transfer to take effect in the future. In *Dickey* v. *Burnet*, 56 F. (2d) 917 (C. C. A. 8th), certiorari denied, No. 88, October Term, 1932, the court held ineffective the anticipatory arrangement by which the taxpayer diverted the deferred profits from the sale of his land to his wife and children.

Petitioner cites in support of his argument, *Hall* v. *Burnet*, 54 F. (2d) 443 (App. D. C.), certiorari denied, 285 U. S. 552. In that case the taxpayer assigned to his wife an interest in a contract with an insurance company under which he was entitled to commissions on all renewal premiums. The question was whether or not such commissions were taxable to the husband. The court held that the contract between the taxpayer and the insurance company gave him a property right in all renewal premiums on all business written for the company by him or by others during the period of the contract and that what was assigned was neither income nor earnings but a property right which is as capable of assignment as any other sort of property. It is submitted the decision is in conflict with the case of *Lucas* v. *Earl*, *supra*.

The contract between the taxpayer and the company was not the thing that produced the income; it merely afforded the opportunity for the taxpayer's personal effort, rendered pursuant to the contract, to produce the income, payment of which was deferred until the premiums were received. Apart from his services no payments would have been made either to the taxpayer or to his wife and the assignment

would not change that fact. The money paid to the wife was compensation for personal services and since the taxpayer was the one who earned it, the money even though it related to past services was his income and he would seem to be taxable for it under *Lucas* v. *Earl, supra.* The decision in the *Hall case* is directly in conflict with the *Bishop case, supra,* and though the court in the latter case distinguished the two cases the difference between them does not seem to be substantial. The effect of the two assignments was the same.

Petitioner also relies upon *Nelson* v. *Ferguson,* 56 F. (2d) 121 (C. C. A. 3d), certiorari denied 286 U. S. 565. In that case the taxpayer assigned a patent to a company under an agreement that the company was to exploit the invention and divide the profits realized, one-third to the taxpayer and two-thirds to the company. He entered into a contract with his wife waiving his rights to the profits and authorizing the company to pay them to his wife. The court held that the right to a part of the profits was a property right susceptible of assignment. The decision is in conflict with *Burnet* v. *Leininger,* 285 U. S. 136, in that the assignment was of income only and not a transfer of the patent or any interest therein or of assignor's rights in the contract. In any event the court in the *Nelson case* excluded from its decision a case involving a tax upon money to be received by a husband in payment for his personal services and pointed out (p. 125) the applicability of the *Earl case* to a situation where "the assigned income sprang

from services which were not property and which of course could not be assigned." This we submit is the situation in the present case.

The other cases cited by petitioner, such as *Copland* v. *Commissioner,* 41 F. (2d) 501 (C. C. A. 7th); *Iowa Bridge Co.* v. *Commissioner,* 39 F. (2d) 777 (C. C. A. 8th); and *Shellabarger* v. *Commissioner,* 38 F. (2d) 566 (C. C. A. 7th), are clearly not in point. In each of those cases there was an assignment of an income-producing asset and not of the income alone. This Court in *Ward* v. *Commissioner,* 58 F. (2d) 757, reviewed the cases dealing with this distinction and further discussion appears unnecessary.

The Supreme Court has denied the Government's petitions for certiorari in *Hall* v. *Burnet, supra,* and *Nelson* v. *Ferguson, supra,* and has also denied the taxpayer's petition in *Dickey* v. *Burnet, supra,* and *Parker* v. *Routzahn, supra.* Hence it appears that despite the seeming conflict in the decisions the Supreme Court considers further consideration of such questions as the one here raised unnecessary in view of the decisions in *Lucas* v. *Earl, supra,* and *Burnet* v. *Leininger, supra.*

Finally, it is not material that the income was paid direct to petitioner's wife. Profits which will constitute income if paid directly to a person are also income to him if paid, pursuant to his agreement, to a third person to discharge his obligation to such third person. *Reynolds* v. *McMurray, supra,* and cases cited therein.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

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